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BETTER POLICIES FOR BETTER LIVES

Interim Economic Assessment

11 March 2014

Ongoing recovery for advanced economies, variation among emerging economies

Overall, most signs point to a continued underlying strengthening of the pace of growth in the major advanced economies, helped by accommodative monetary policy and reduced fiscal drag. Transitory factors however result in uneven profiles for near-term GDP growth in several cases.

Among major emerging market economies (EMEs), the picture is more mixed, with some countries continuing to grow strongly while others, where underlying vulnerabilities have been highlighted by reversals of capital inflows, are experiencing a marked loss of momentum. Given that emerging economies now account for over half the world economy, continued sub-par economic performance for several of the major EMEs is likely to mean that global growth remains only moderate in the near term.

Some prominent risks to the growth outlook have waned, although others remain present and new ones are appearing.

The gradual scaling down of monetary stimulus has rightly begun in the United States, where a cyclical recovery is relatively well established. The continued uncertainty about the strength of that recovery, however, together with the volatility that this scaling down has created in some emerging markets, suggest that it would be best to proceed cautiously, with a careful communications policy to smooth expectations. Meanwhile, in the euro area and Japan, where the recovery is less established and inflation remains below target, the degree of monetary policy stimulus should be maintained or even increased.

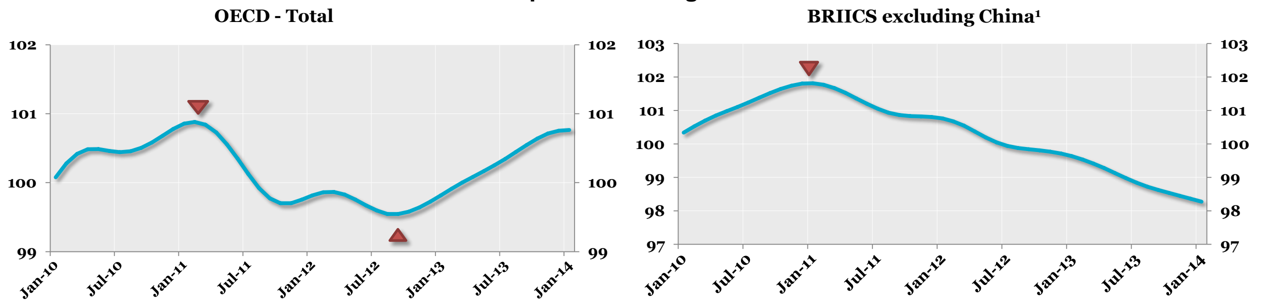
Fiscal consolidation needs to continue, although progress already made in many cases means that the pace of consolidation can be slower this year than last, reducing the drag on growth.

Structural reforms to improve the functioning of the economy in the long run are not a substitute for suitable macroeconomic policies, but if well-chosen can be a useful complement. Moreover, given uncertainty over the extent to which sub-par growth in recent years can be explained by cyclical weakness versus slower growth of potential output, structural reforms to boost potential are an increasingly important adjunct to a demand-supportive macroeconomic policy mix.

In the advanced economies, an ongoing recovery is partly masked by temporary factors

- The growth rate for the G7 economies as a whole declined in the last quarter of 2013, largely on account of a slowdown in the United States due in part to the government shutdown in October and a first bout of unusually severe winter weather in December. Nonetheless, in most of the major advanced economies fourth quarter GDP growth was better than expected, and Consensus forecasts for 2014 have ratcheted up over the last few months.
- Indeed, the underlying picture continues to be of strengthening growth momentum in the major advanced economies. For example, the OECD's Composite Leading Indicators (CLIs) show a rising profile for the United States, the euro area, Japan and the United Kingdom. This contrasts with the CLIs for the major emerging economies excluding China, which in aggregate are signalling a continuing cyclical slowdown.

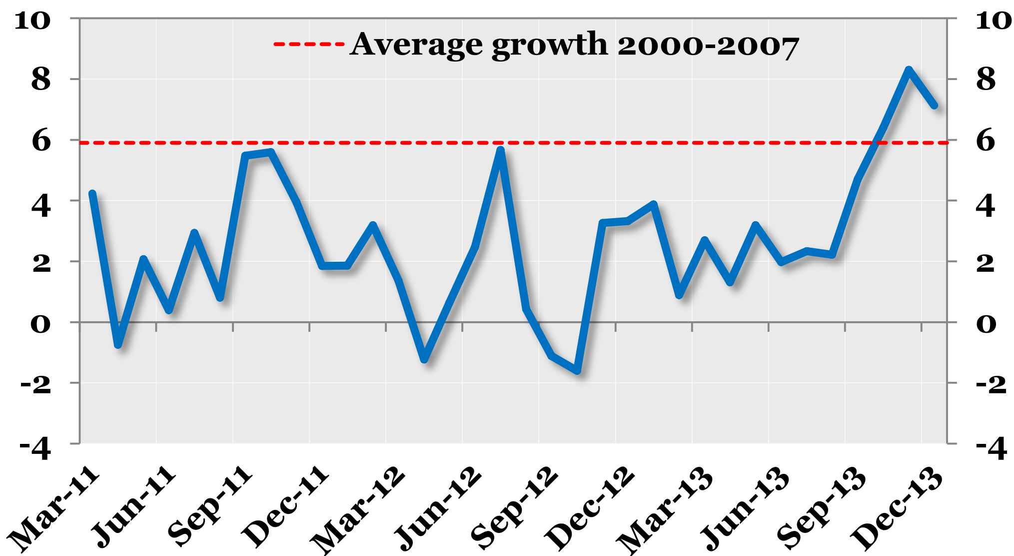
OECD Composite Leading Indicators



Note: Long-term average=100.
1. Weighted average of Brazil, Russia, India, Indonesia and South Africa, where weights are 2005 GDP at USD PPP.
Source: OECD Main Economic Indicators database.

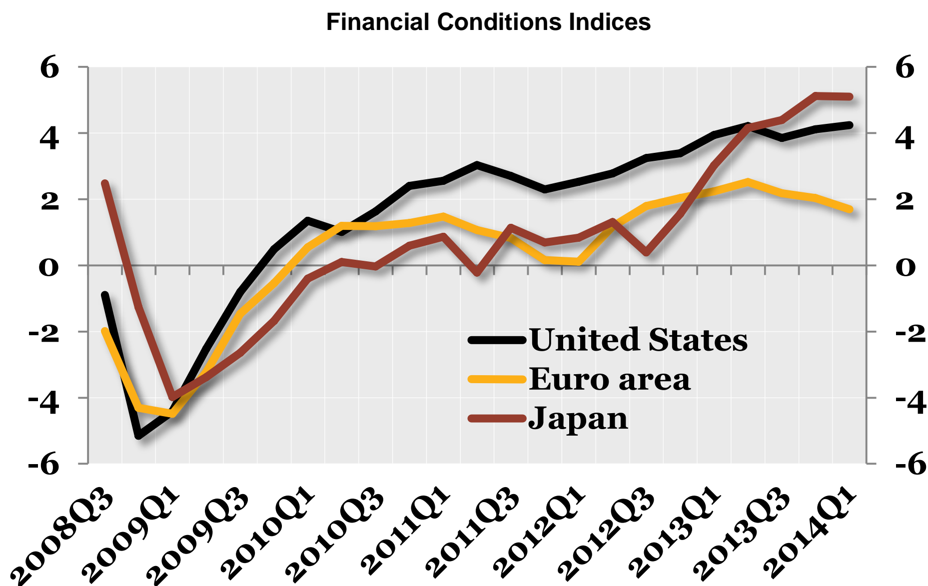
- The pick-up in growth in the major advanced economies has been reflected in an acceleration of world trade volumes, after an extended period of unusually sluggish growth. This may signal a rebound in business investment, which has also been weak in recent years, as investment is relatively trade-intensive.

World merchandise trade volumes
Annualised 3-month moving average growth



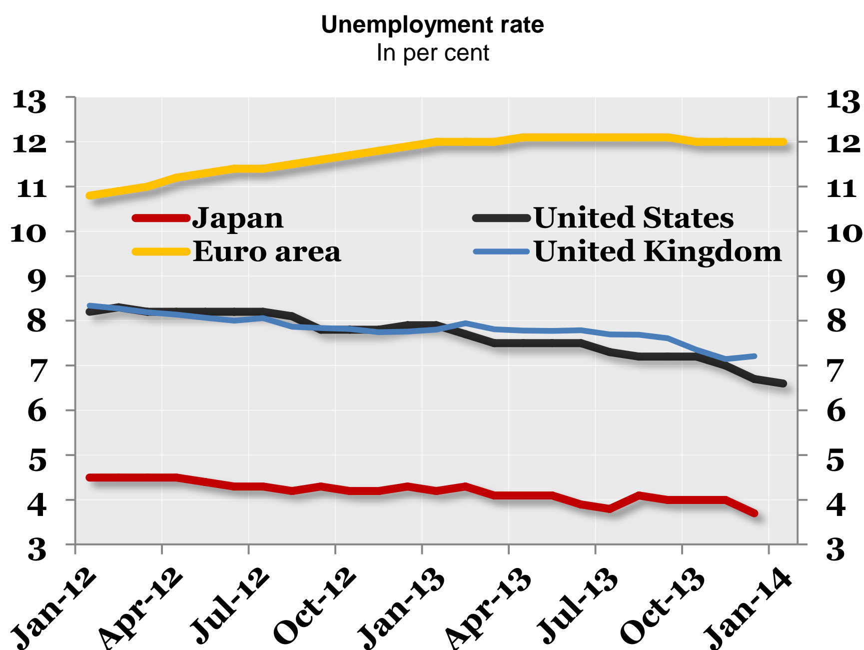
Source: CPB World Trade Monitor.

- Growth in the advanced economies continues to be supported by easy financial conditions. The OECD's Financial Conditions Indices, which take into account changes in the exchange rate and short- and long-term interest rates as well as the change in credit availability, corporate bond spreads and household wealth, increased substantially in the United States, the euro area and Japan from late 2011 through about mid-2013. They have stayed at high levels since then, though with some retracement in the euro area in recent months, mainly reflecting appreciation of the euro.



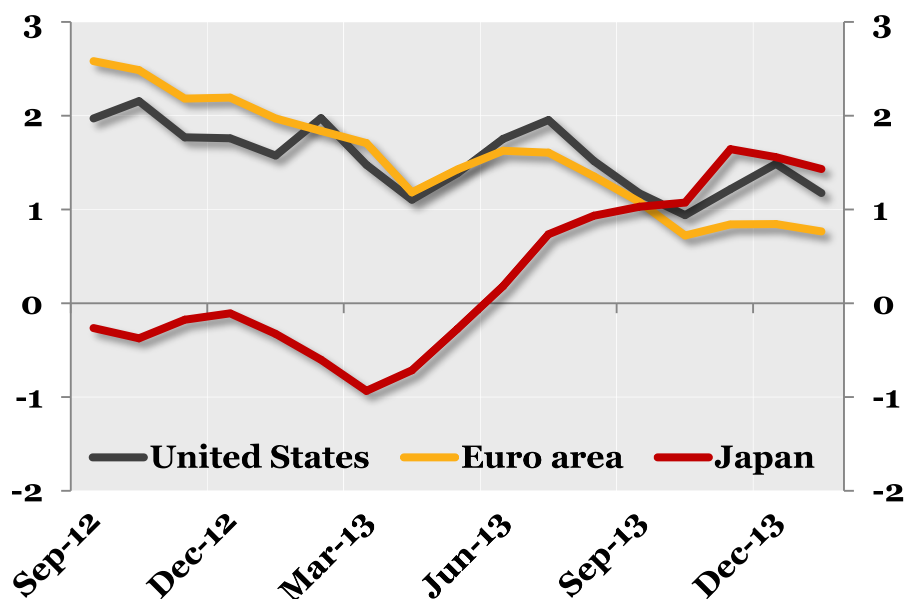
Note: A unit increase in the index implies an easing in financial conditions sufficient to produce an average increase in the level of GDP of 0.5-1% after 4-6 quarters.
Source: Datastream; OECD Economic Outlook 94 database; and OECD calculations.

- While activity in the euro area appears to be improving, so far it is doing so later and at a slower pace than in the other major economies. Notably, while unemployment has been falling elsewhere, it has remained flat at stubbornly high levels in the euro area.



Note: Monthly data for Japan, the United States and the euro area, rolling 3-month average for the United Kingdom.
Source: OECD Short Term Labour Market Statistics; Eurostat; Office for National Statistics.

- Inflation dynamics also highlight the relative weakness of demand in the euro area. While Japan appears finally to be exiting from deflation and inflation in the United States is likely to edge back up towards the 2% range as the output gap closes, inflation in the euro area has fallen further below target and is likely to stay very low for an extended period, given that an economic recovery is just getting underway. Moreover, inflation is close to zero in many euro area member countries and negative in a few, with deflation threatening to take hold in a number of the countries in the periphery. Differential inflation rates are to be expected as part of the adjustment of current account balances, but it would be less costly if it were achieved with positive inflation throughout the euro area.



Note: Headline HICP for the euro area, headline CPI for the United States and Japan.
Source: OECD, Main Economic Indicators database; OECD, Economic Outlook database; Eurostat; and OECD calculations.

- In Japan, the first year of Abenomics yielded a welcome rebound in GDP, but the necessary fiscal consolidation which gets under way in earnest this year is likely to exert a drag on growth in the near term and result in an uneven quarterly growth pattern. In particular, the hike of the consumption tax rate on April 1st is pulling up activity in the current quarter as consumers bring forward purchases, but is likely to be followed by a contraction in the second quarter, and a recovery thereafter.

- The United States and Canada are both also expected to experience an uneven pattern of growth in the near term, owing in part to the disruptive effect of repeated episodes of severe winter weather. A number of activities were restrained by the storms and cold temperatures, which is likely to depress first quarter GDP, with some bounceback effect in the second quarter in the absence of further negative shocks.

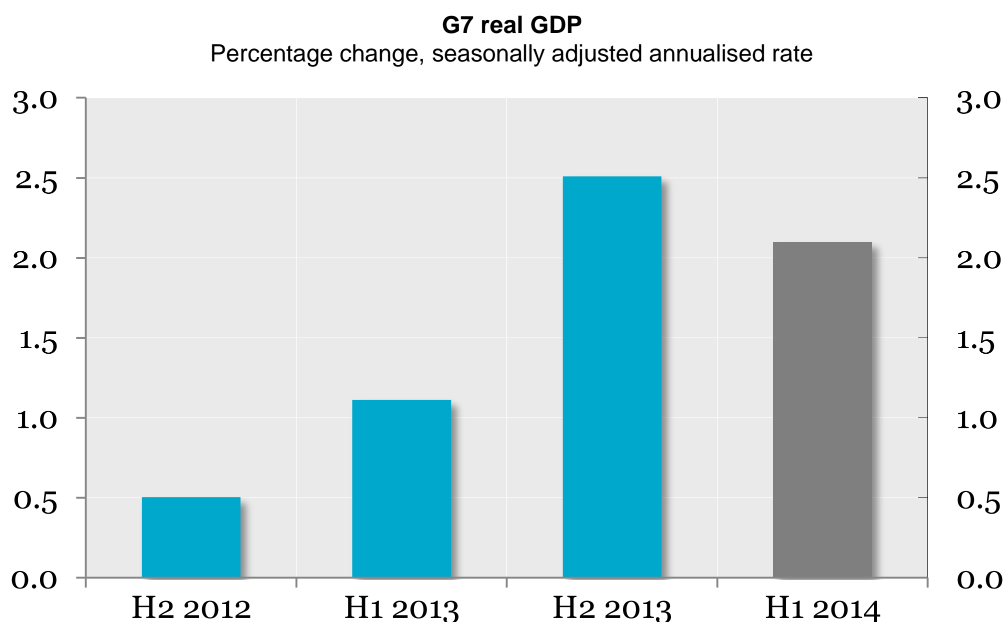
- The one-off factors in North America and Japan have the effect of masking a continuing underlying recovery among the major advanced economies as a whole.

Indicator-based forecasts for GDP growth in the major economies

	2013Q3	2013Q4	2014Q1	2014Q2
United States	4.1	2.4	1.7	[3.1]*
Japan	0.9	0.7	4.8	[-2.9]*
Germany	1.3	1.5	3.7	2.5
France	-0.2	1.2	0.7	1.0
Italy	-0.1	0.5	0.7	0.1
United Kingdom	3.4	2.9	3.3	3.3
Canada	2.7	2.9	0.5	[2.4]*
G7	2.8	2.0	2.2	2.0
Euro area 3[1]	0.5	1.2	1.9	1.4

Note: Based on GDP releases and high-frequency indicators published by 10 March; seasonally and in some cases working-day adjusted. See Appendix for underpinnings and status of the indicator model projections.
1. Weighted average of Germany, France and Italy.
* All numbers based on OECD indicator model, except for the United States, Japan and Canada, where the numbers for 2014 Q2 are from the November 2013 Economic Outlook, owing to one-off factors that cannot be captured by the model.
Source: OECD Interim Forecast.

- The projections suggest that growth for the major advanced economies in the first half of 2014 will be somewhat slower than in the second half of 2013, but much improved from the sluggish rates of late 2012 and early 2013. In the absence of the one-off factors, it is likely that the profile of G7 growth would have been more consistent with the strengthening that we see as ongoing through this year and next.



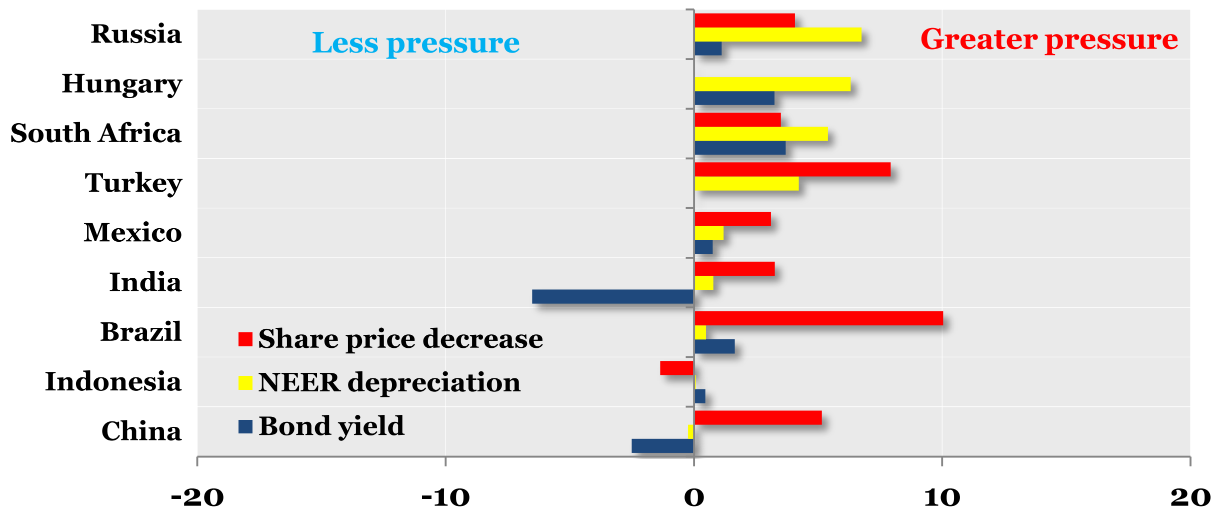
Source: OECD Main Economic Indicators; OECD interim projections.

The outlook is, as ever, beset with risks, although some previously prominent ones have eased

- Compared to the previous OECD *Economic Outlook,* released in November 2013, some salient risks have diminished. In the United States, political wrangling over the financing of government operations and the federal government debt ceiling has subsided. Generally positive surprises on GDP outcomes in advanced economies in the fourth quarter, combined with mostly favourable financial market developments, have improved the outlook for stressed banking systems, especially in Europe. And there has been some further progress on structural and financial reforms.

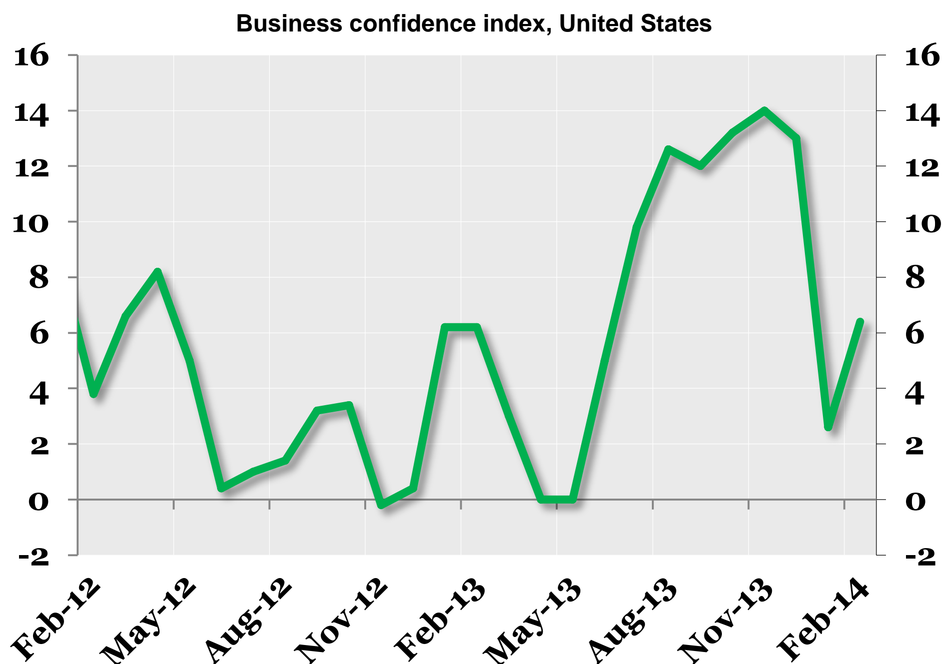
- Nonetheless, some long-standing risks remain. Japan is only just beginning to confront its daunting fiscal challenges, fragilities in the euro area are still acute, and the possibility persists of a sharp slowdown in China driven by balance sheet effects. In addition, the adjustment of monetary policy in advanced economies as the cycle progresses continues to pose a risk to stability in some emerging economies, and crises there could spread and in turn exert a drag on growth in advanced economies.

- The initial effect on EMEs of the decision of the United States Federal Reserve in December to begin tapering its asset purchases was limited, but turmoil flared up in late January, leading to currency weakness and falling bond and equity prices. In some cases (Turkey, South Africa, Brazil, India), central banks found themselves forced to tighten policy in order to stem capital outflows.



1. Period from 2 January to 3 February.
Source: Datastream.

- The January volatility episode was more limited than the financial market turmoil in the summer of 2013 after the Federal Reserve raised the possibility of an earlier-than-expected tapering of asset purchases. The Federal Reserve has subsequently refined the communication of its policy with a view to avoiding disruptive surprises. However, as the scaling down of monetary accommodation proceeds in the United States, and with increased financial market scrutiny of vulnerabilities in EMEs, there remains a risk that the financial market volatility and strong capital outflows in recent months in some emerging economies could again intensify, exerting an additional drag on growth. High levels of debt built up during recent years increase the vulnerability to financial shocks.
- One new risk relates to the dip in momentum in the United States economy, with a number of indicators faltering in late 2013 and early 2014. While part of this weakness is related to the unusually severe weather and should be reversed, it is unclear to what extent less transitory factors are also at play. At least part of the weakness in home sales, for example, appears to be related to the rise in long-term interest rates over the last year. In addition, if the recent economic weakness were to durably depress confidence, it could undermine the recovery.



Source: OECD Main Economic Indicators database.

A demand-supportive macroeconomic policy mix is still needed in advanced economies

- Overall, the recovery underway in the advanced economies is still in its early stages and needs nurturing via an accommodative policy mix, although divergences in recovery speeds and inflation prospects call for differing policy stances in the major OECD areas.
- Given the more advanced recovery in the United States, the scaling down of quantitative easing has begun, and a gradual withdrawal of monetary stimulus should be carried out over the coming two years. In Japan and the euro area, however, supportive monetary conditions must be maintained, with a possible need for further stimulus.
- In most major advanced economies, high and still-rising government debt burdens mean that fiscal consolidation should continue. In the United States and the euro area, however, the considerable progress already made means that consolidation can slow this year relative to 2013. By contrast, Japan is faced with the need to implement steady consolidation for a number of years in order to restore fiscal sustainability.

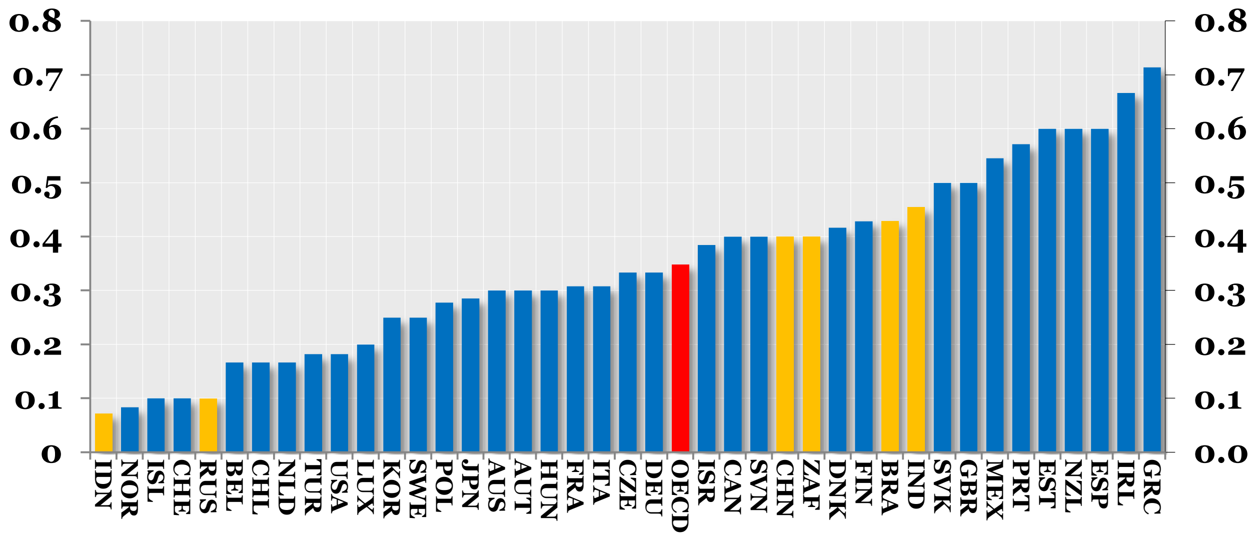
Volatile capital flows are likely to continue to create policy dilemmas in some EMEs

- In China, growth is around trend and inflation is well contained, but monetary and macroprudential policy need to restrain credit growth, which would help address the growing vulnerability of the financial system. Further interest rate liberalisation, in particular for household deposits, is also called for. Fiscal policy in China is broadly neutral. As rightly recognised in the 3rd Plenum report, the central government needs to impose harder budget constraints on local governments, improve transparency and better monitor local government spending.
- Other EMEs are typically more exposed to swings in capital flows and exchange rate pressures, and in some cases these pressures may force a tightening of monetary policy to keep inflation expectations anchored, even where growth is weak. In a few cases it may be possible to ease fiscal policy to offset the contractionary effect of tighter monetary policy, but some EMEs are constrained by the need to reduce budget deficits.

Structural reforms could make a major contribution to strengthening growth and stability

- In both advanced and emerging economies there has been a growth slowdown since the crisis, which appears to reflect a combination of cyclical weakness and structural deficiencies. Moreover, the two are not neatly separable, with unemployment created by cyclical slowdowns at risk of becoming permanent, requiring structural policy measures for it to be fully reversed. Structural policy failings, notably as regards the regulation of the banking system, mean that vulnerabilities to financial instability remain. Progress in these areas has become increasingly pressing.
- One important initiative in 2014 will be the asset quality review and stress tests to be conducted in the euro area. It is essential that these exercises be seen as credible and be followed up so as to restore confidence in the financial system and facilitate renewed credit growth.
- Growth-friendly structural policies can help to invigorate investment, revive trade growth and drive innovation via stronger competition. The OECD's *Going for Growth* exercise identifies five structural policy priorities for each country every two years. Indices of the responsiveness of OECD countries and the BRIICS to these priorities suggest that most countries could do much more to boost their long-term growth rates. Some countries, notably those under most pressure during the global crisis, have had high responsiveness rates, but on average, OECD economies have taken significant action on only about one third of *Going for Growth* priorities in 2012-13.

Responsiveness to Going for Growth priorities
Responsiveness rate, 2012-13



Note: Responsiveness rates are calculated as the share of priority areas in *Going for Growth* in which 'significant' action has been taken. The euro area and OECD rates are calculated as unweighted averages. OECD countries are shaded in blue, non-OECD countries are in yellow, and the OECD average is in red.

Source: OECD calculations based on *Going for Growth* 2014.

Appendix

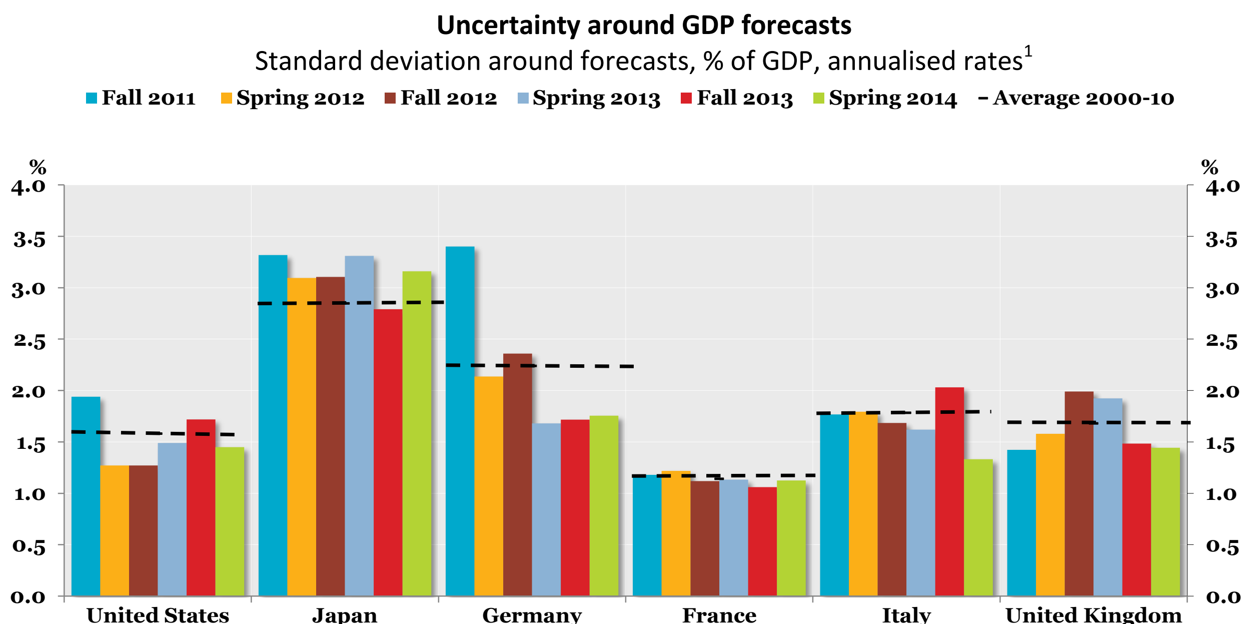
Status and underpinnings of the Indicator-based Forecasts

The Indicator-based Forecasts in this assessment do not represent a full update of the biannual *Economic Outlook* projections. The Interim Forecasts cover only GDP over a short horizon for a small number of countries, and rest on more limited information set than the *Economic Outlook*. However, the Interim Forecasts help evaluate the extent to which the latest *Economic Outlook* projections are still on track.

The main tool is a suite of indicator-based models that serve to forecast real GDP for each of the G7 economies.[1] The models cover the two quarters following the last one for which official data have been published, with the different models receiving equal weights in the computation of the published forecast. They use a small, country-specific selection of monthly indicators, hard (*e.g.* industrial production, retail sales) and/or soft (*e.g.* business confidence). These models have been shown to outperform a range of other models relying solely on published quarterly data, as regards both forecast-error size and directional accuracy. The models used for the US and the UK economies have been modified to better capture the influence of developments in the housing sector, with the inclusion of various forward-looking housing indicators.

Uncertainty around the forecasts

The standard deviation as a measure of uncertainty captures the divergence in GDP forecasts across the soft-, hard- and mixed-indicator models as well as within-model uncertainty, which may for instance reflect imprecisely estimated coefficients. In contrast to standard measures of uncertainty such as root mean squared forecasting error (RMSFE), the standard deviation around the forecasts based on quantile regressions reported in the figure below is contingent on current economic circumstances and may vary significantly over time.[2]



1. The standard deviation combines two sources of uncertainty. First, there is uncertainty due to differences in forecasted GDP between the three models (soft-, hard- and mixed-indicator models) that are used to make the projections. Second, uncertainty around the GDP forecasts of each individual model is derived using quantile regressions, which allow some explanatory variables to have more weight in explaining GDP during a sharp downturn (or recovery) than in more normal times. For technical reasons, this analysis is not reported for Canada and China.

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1 See Pain, N. and F. Sédillot, "Indicator models of real GDP growth in the major OECD economies", *OECD Economic Studies*, No. 40, 2005 and Mourougane, A., "Forecasting monthly GDP for Canada", *OECD Economics Department Working Papers*, No. 515, 2006.

2 Laurent, T. and T. Kozluk (2012), "Measuring GDP Forecast Uncertainty Using Quantile Regressions", *OECD Economics Department Working Papers*, No. 978, 2012.